January 13, 2006

Watson Gin, Deputy Director
Department of Toxic Substances Control
1001 I Street, 10th Floor
P.O. Box
Sacramento, CA

Via email: wgin@dtsc.ca.gov

SUBJECT: COMMENTS ON NOVEMBER 29, 2005 WORKSHOP ON FINANCIAL ASSURANCE MECHANISMS

Dear Mr. Gin:

I am writing to you regarding the workshop that the Department of Toxic Substances Control (Department) held on November 29, 2005 to discuss two financial assurance mechanisms that are used by hazardous waste service providers to provide closure and post-closure care for hazardous waste facilities in California: Captive Insurance and the Corporate Financial Test.

Waste Management operates the Kettleman Hills Treatment Facility in Kings County and currently uses the Captive Insurance mechanism to provide post-closure care financial assurance for this facility. We use both mechanisms at many of our facilities throughout the United States to meet our financial assurance obligations. We are extremely concerned about the discussion of these two mechanisms at this recent workshop and at other workshops that preceded it.

WM currently operates approximately 300 land disposal facilities nationwide, most of which are subject to the Financial Responsibility provisions of Part 258 (for municipal solid waste (MSW) landfills) or Part 264 (for hazardous waste treatment, storage, and disposal facilities). WM is the largest waste services company in the United States and its total assets exceed $20 billion. *The value of the company greatly exceeds its financial assurance obligations.*

WM deploys a variety of means for its financial assurance obligations, including letters of credit, surety bonds, corporate financial test, and insurance. The decision to deploy any particular instrument at a site is a function of state requirements, market factors that influence the cost of the instruments, and prudent management of the company's finances. Currently Waste Management uses the following relative percentages of total financial assurance dollars covered by each allowable financial assurance mechanism we use to meet our nationwide hazardous and solid waste facility financial assurance obligations:

Nationwide Landfill Financial Assurance Mechanism Use by Waste Management (% of Total Financial Assurance Dollars)

Mechanism	***Hazardous Waste Landfills***	***Solid Waste Landfills***
Captive Insurance	28%	32%
Commercial Insurance	0%	1%
Financial Test	13%	6%
Letters of Credit	36%	16%
Surety Bond	23%	45%

We believe it is clear from this chart that Waste Management employs a wide diversity of financial assurance mechanisms for our total portfolio of facilities. The use of Captive Insurance and the financial test represent only about 30% and 10% respectively of our total dollar coverage of the financial assurance mechanisms we use. Significantly more than 50% of our total financial assurance is provided by mechanisms other than Captive Insurance or the Corporate Financial Test. We do not believe that there is any need for California to prescribe limits or percentages on the amount for any particular financial assurance mechanism at a particular facility. There is already a wide spread use of a variety of financial assurance mechanisms throughout Waste Management's nationwide operations.

In addition, we are still not clear why the Department has chosen to raise concerns about these two particular financial assurance mechanisms. The Department may have had problems in the past with other financial assurance mechanisms, but we are unaware of any specific problems that have been identified with the use of these two financial assurance vehicles that are based on historical fact or actual experience. For the most part, the problems that the Department has identified with these two mechanisms are wholly speculative in nature – and for those that are real, the problems are relatively minor in nature and easily addressed. We respectfully suggest that the Department should focus its regulatory efforts in those areas in which actual problems are known to exist and can be clearly remedied through regulatory action.

Captive Insurance

Because WM's asset base is so diverse and substantial, the company considers it prudent to use Captive Insurance for a portion of its financial assurance responsibilities. Formed by WM and licensed by the State of Vermont in 1989, the National Guaranty Insurance Company of Vermont (NGIC) is a wholly owned subsidiary of WM. As such, it is

considered a "pure Captive Insurance company" and is authorized to write insurance and issue surety bonds for WM only. While WM is the parent of NGIC, NGIC is a separate, regulated entity that is financially solvent in its own right. NGIC can meet its closure, post-closure, and corrective action obligations because the assets dedicated to those programs are not available to the parent company for alternative uses. Nonetheless, due to its financial strength, WM is currently financing scores of closure, post-closure, and corrective action activities without having to use the assets of NGIC.

Waste Management believes that Captive Insurance is a viable and vital form of risk management for solid and hazardous waste and should be retained as an acceptable instrument for financial responsibility. Attached to this letter is a more thorough description of the regulatory structure of the Captive Insurance Industry in the State of Vermont (Attachment A). Also attached are charts describing the growth of the Vermont regulated Captive Insurance industry (Attachment D). If you require more information regarding the regulatory structure established by the State of Vermont, we suggest you contact Derick White, Director of Captives, with Vermont's Captive Insurance Division. More information about this program, Mr. White's contact information, can be found at:

http://www.bishca.state.vt.us/Captive/capindex.htm

Waste Management requests that DTSC consider the following information:

- There are currently over 4,000 captives licensed worldwide. Captive Insurance helps States and regulated entities to fulfill their financial obligations consistent with EPA's stated policy of providing a broad array of mechanisms to facilitate the economically sound financing of financial assurance obligations. One of the chief functions of a captive is to facilitate the efficient financing of risk within an organization. In addition, captives form part of an overall financial planning structure for a corporation and can act as a shield against upswings and downswings in the commercial market.

- Vermont has licensed over 700 captives, which makes it the largest domicile in the U.S. This is attributable chiefly to the excellence of its regulatory control and administration. Nearly half of the Fortune 500 companies have opted to domicile their captives in Vermont.

- *The Vermont regulated Captive Insurance industry has the highest performance record within the insurance industry*. The State of Vermont responds rapidly at any sign of failure to perform, and has had remarkable success with regulating captives, especially when compared to "traditional" commercial insurers domiciled in other states. Attached to this letter is list of recent known Insurance Company failures during the past several years (Attachment B) – all regulated under "traditional" (non-captive) insurance codes. As far as we know, not a single one of these failures involved a Vermont regulated Captive Insurance company.

- The owners of Captive Insurance companies are typically sophisticated entities with the ability to manage and retain their own risk.

- WM's captive, NGIC, is currently active in 19 states for financial assurance and 30 states for performance/miscellaneous obligations.
- Vermont holds captives to a rigorous set of requirements before licensing, and then monitors the ongoing operations and financial stability of captives. Captive insurers are required annually to provide to the Vermont Insurance Department extensive information (See Attachment C).
- NGIC has irrevocable, evergreen letters of credit in favor of the State of Vermont for $141 million, and an inter-company note, payable upon demand, with Waste Management for an additional $190 million. The State of Vermont can require this inter-company demand note to be replaced immediately with letters of credit or cash if WMI fails to meet required financial standards at any time. This ability to call the inter-company demand note allows Vermont to ensure that sufficient funds are available to NGIC to cover any foreseeable claim or demand for payment – fully independent of Waste Management.
- NGIC's management company is Marsh Management Services Inc. Marsh is the largest manager of captive insurers in the country. Their knowledge of and experience with insurance companies of all kinds, including experience with captives, was a key element of WM's decision to contract with them. Marsh provides key services including issuance of policies, assistance in determining appropriate rate and policy conditions, statistical information for regulators, premium billings, accounting, regulatory compliance and actuarial certifications.
- If at any time Vermont determined that NGIC was not adequate for its intended purpose, WM would have to replace that financial assurance mechanism immediately.

Assignability

Assignability as it relates to Captive Insurance is an anomalous provision of the RCRA financial assurance requirements, and there is no evidence to indicate that the provision was intended to impede the use of captives.

The Department has raised concern about the assignability of Captive Insurance instruments when ownership changes at a permitted hazardous waste facility. However, this is not really a problem because the Department must approve the financial assurance instruments of a new owner of a hazardous waste facility – prior to the transfer of the permit. There is no reason why an insurance instrument needs to be assignable given Department's complete control over the ownership transfer process. The Department has adequate authority to ensure that there is not a "gap" in financial assurance coverage at a permitted facility. At its July 31, 2001 meeting with the Association of State and Territorial Solid Waste Management Officials, EPA cautioned against a presumption that the assignability provision was intended to limit or prohibit the use of captives. EPA acknowledges that the record for the development of the assignability provision is

sketchy or non-existent, and one can only turn to other events to provide context for the provision.

- For MSW landfills subject to Part 258 of the federal solid waste regulations, the assignability provision at Section 258.74(d)(5) is sandwiched between two other provisions in the regulations. Both of these provisions are intended to protect the owner/operator, apparently in the context of commercial insurance. Section 258.74(d)(4) allows the owner/operator to receive reimbursements for undertaking closure or post-closure activities. Section 258.74(d)(6) protects the insured, the owner/operator, against cancellation except for premium default. The placement of the assignability provision in context indicates an attempt to protect the insured against an unreasonable failure to reassign by the insurer, in which case the provision may only be read to be appropriate for commercial insurance, as a captive insured would have no need for such protection.
- In 1988, in preamble language to amendments of the financial responsibility provisions of Parts 264 and 265 of the federal hazardous waste regulations, EPA acknowledged the existence of Captive Insurance as an acceptable instrument. This notice took place several years after the assignability provision was first established in these sections, and was already being used by the regulated community.
- As noted above, Captive Insurance has been used with unmatched success as a financial assurance instrument for at least 16 years, and in that time, neither DTSC nor US EPA has identified any real problem that has been created by limits on the assignability of captive insurers.

Given the above circumstances, we believe there is no reason for the Department to conclude at this juncture that the assignability provision should be an impediment to the continued use of Captive Insurance.

Waste Management Recommendations with Respect to Captive Insurance

To resolve the assignability issue, the Department should promptly proceed with an interpretive guidance, direct final rule, or a technical correction to the regulations regarding the assignability of Captive Insurance Instruments.

EPA, the States, and the regulated community have proceeded for over a decade on the assumption that Captive Insurance was a viable financial assurance instrument, and the history of its use and effectiveness support the merits of that assumption. Captive Insurance fulfills the principal purpose of financial assurance as identified by EPA in its rulemakings, to provide assurance only in the event that an owner/operator is unwilling or unable to pay for closure/post-closure care. In that regard, WM understands that no captive has ever been called upon to fund a closure or post-closure obligation. In addition, there is no evidence that the assignability provision was intended to limit or prohibit the use of Captive Insurance. If that were not the case, there would be no explaining EPA's long silence on the use of the instruments or EPA's determination in

another rulemaking that Captive Insurance is a viable instrument. All evidence suggests that the existence of the assignability provision came about without EPA consideration or judgment as to its potential effect on the Captive Insurance instrument. With this history, it is entirely appropriate for the Department to correct the regulations in one of several ways:

(1) The Department can amend the language of the assignability provision to remove its applicability to Captive Insurance policies.

(2) The Department can amend the language of the assignability provision to provide an alternative condition that in the case of Captive Insurance, in lieu of assignability, there will be no lapse of coverage for financial assurance in the event of a change of ownership and/or operation to a new permittee.

(3) The Department can provide clarifying language that the assignability provision is intended solely for non-Captive Insurance policies where an issue of asset recovery for the insured may exist.

(4) The Department can defer to US EPA's nationwide interim resolution of this issue.

The Department should examine the record and financial integrity of Captive Insurance programs, with the Vermont program as a model, and retain the use of Captive Insurance for meeting financial responsibility obligations. By doing so, the Department will maintain diversity in the market place, maintain access to the financial assurance mechanism with the best performance track record, and prevent an unwarranted flight to potentially riskier mechanisms.

A thorough review of the Vermont program will provide strong evidence that Captive Insurance should remain among the instruments for use by the regulated community. In that regard, WM recommends that the Department consider developing guidance or regulatory amendments for the use of the Captive Insurance instrument that contains the following elements:

(1) The licensing state should establish an annual review process for the captive insurer which will include the submission and review of audited financial statements, an annual report by the company with financial and insurance operational information, financial statements of the parent company, and biographical affidavits on the officers and directors of the Captive Insurance company.

(2) If loan backs are to be used as part of the captive insurer's capital base, the parent company should have equity of at least $100 million and an investment grade bond rating. Provisions should be established to require repayment of the loan if the financial condition of the parent company should so warrant.

(3) The combined ratio generally should not be greater than 100%. (The combined ratio is simply the measure of insurance company expenses (including losses and administrative expenses) compared to premium dollars received. A ratio above 100 means that for every premium dollar taken in, more than a dollar went for losses and administrative expenses.)

(4) Premiums written to surplus ratio should not generally exceed 300%. (This ratio attempts to measure the adequacy of an insurer's surplus, relative to its operating exposure. A low ratio indicates stronger surplus support for net premiums written and less exposure to a material reduction in surplus arising from a sudden downturn in underwriting results.)

WM opposes the establishment of the minimum insurance rating recently suggested by the Department.

The Department has suggested that a minimum insurance rating for all insurance coverage would provide an extra measure of confidence in the insurance mechanism. WM believes that such a measure would be counterproductive and would only increase costs and flexibility for owner/operators without any substantive improvement in the financial responsibility program.

- The establishment of a specific minimum rating as suggested by the Department appears to be arbitrary and does not identify any analysis of what problem the Department is trying to solve, other than one of appearances, nor does the Department articulate how the rating will improve the program compared to any other rating. By simply arbitrarily choosing a minimum insurance rating the Department would simply be attempting to address the *fears* of regulators unfamiliar with insurance practices or risk management methods, rather than any substantive concerns with the insurance instrument itself. The US EPA has clearly stated that its policy is to promote a variety of financial assurance instruments. The Department should do the same. Any proposal that may restrict the use of an otherwise viable instrument, such as insurance, must meet a threshold test for necessity or program integrity. The Department has failed to undertake such an analysis in its proposal for a minimum insurance rating.
- The Department has not analyzed how any specific minimum insurance rating may affect the cost of insurance to the regulated community. Market circumstances have tightened the market for financial assurance instruments, and further restrictions on the participation of insurance providers will only serve to exacerbate the costs. The Department must analyze and document those potential costs before it can determine whether the marginal benefits of confidence or protection it may superficially obtain with a minimum insurance rating exceeds the likely costs or the potential flight to riskier instruments.

The Financial Test

Waste Management believes that Financial Test and Corporate Guarantee (hereafter "Financial Test") is an essential tool in the array of financial assurance mechanisms that must continue to be made available to solid and hazardous waste service providers. As is true with Captive Insurance, the Department acknowledges that there have been no instances where DTSC had to perform closure, postclosure, or corrective action activities where a facility owner/operator actually using the financial test has failed. The same is

true elsewhere in the US – there is no known failure of a solid or hazardous waste service provider using the Financial Test to meet its financial assurance obligations at the time the Financial Test was being used to provide financial assurance.

For financially strong companies, such as Waste Management, the Department's existing regulations provide low-cost mechanisms such as the financial test (and Captive Insurance) that relies upon the inherent strength of the company to assure performance of its obligations.

The US EPA adopted the Financial Test only after long and careful analysis of competing considerations and supporting evidence. For example, EPA decided to use fairly simple measures to evaluate financial performance for the purpose of determining whether a company would be able to cover its financial assurance obligations. These include readily available measures such as a company's bond rating, its tangible net worth, and its net working capital. The Financial Test is actually quite conservative – only the strongest of company's can use this mechanism.

- Financial Tests/Corporate Guarantees should continue to be viable instruments for strong, financially sound companies to use if it meets the required criteria. The information is updated and provided to the state regulatory authority on an annual basis with a letter from the company's auditing firm attesting to the financial information submitted in the documentation. If a Director of an approved State has concern over the financial condition of a particular company, it can require at any time the owner/operator to provide reports of its financial condition. The Director can require the owner/operator to provide alternate financial assurance if they no longer meet the requirements.
- The bond rating of the owner/operator reflect the expert opinion of bond rating services and evaluates the firm's financial management practices. The rating firms, S&P and Moody's, are well respected and widely utilized sources for credit ratings.

The Department's concerns regarding the Financial Test are overstated by suggesting that the Financial Test "provides absolutely no certainty as the amount or the availability of funds." "Certainty" is clearly an elusive goal in virtually every human endeavor. In reality, the Financial Test, as amply demonstrated by its track record, provides an excellent assessment of the current financial strength of a company and the likelihood of financial problems in the foreseeable future.

The Financial Test was designed by the US EPA to cover a 3-year "look-ahead" period. EPA determined that companies using the Financial Test are highly unlikely to seek bankruptcy protection or default on their financial assurance obligations over the "next 3 years". This is ample time to allow a company, if it fails to meet the criteria of the Financial Test, to transition to other financial assurance mechanism. In fact this has indeed happened a number of times in the past – again there has never been a failure of a company using the Financial Test to meet is financial assurance obligations. Because a company using the Financial Test must re-qualify every year, there is always a 2-year "look-ahead" period during which default is highly unlikely. The US EPA has reviewed this issue several times and has continued to reaffirm its original analysis.

Although the Department has suggested that the Financial Test might be eliminated or radically changed in favor of more liquid forms of financial assurance, it has not evaluated the significant costs of such a change and the disruption it would cause in the financial assurance market place. Waste Management recommends that only relatively minor adjustments are warranted to the Financial Test at this time.

The Department should be aware that US EPA's Environmental Financial Advisory Board (EFAB) is currently review and making recommendations regarding the Financial Test. At a minimum, the Department should defer significant regulatory action on the Financial Test until such time as EFAB has completed its evaluation and issued its recommendations. For more information on EFAB, please go the to following website. EFAB has clearly included this effort in its workplans for 2004, 2005 and 2006:

http://www.epa.gov/efinpage/efab.htm

Waste Management Recommendations Regarding the Financial Test

To resolve the "Negative Assurance" issue, the Department should promptly proceed with an interpretive guidance, direct final rule, or a technical correction to the regulations regarding "Negative Assurance".

Although the DTSC workshop materials suggest that regulatory changes are needed to the Financial Test to address Negative Assurance issue, we do not believe this to be the case. Although the current regulatory situation is clearly confusing and somewhat unique, it should not pose an overwhelming obstacle for the continued use of the Financial Test.

EPA's 1982 financial assurance rules require each company relying upon the financial test to submit a special report from its independent certified public accountant. That special report must include a statement that he/she has compared the company's audited financial statements with the letter from the company's chief financial officer summarizing certain data from those statements and that "no matters came to his attention which caused him to believe that the specified data should be adjusted." This statement "that no matters came to his attention" is commonly referred to as the "negative assurance" provided by the accountant. The wording of the equivalent DTSC regulations is virtually identical and clearly based on US EPA's 1982 regulations. Indeed, most other states have adopted this language as well.

However, in 1995, the Auditing Standards Board of the FASB issued new standards that effectively prevented accountants from giving negative assurances in cases where the client and the independent accountant enter into an agreement that defines the scope of the accountant's work. This has created some regulatory confusion because the financial test regulations required "negative assurances" -- but the accountants were no longer able to provide them under the new rules of practice. However, this should not really be a problem because all other aspects of the accountant's work remains the same and substantially the same review is performed – but without a "negative assurance" statement.

In fact, EPA recognized that substantially nothing had changed by issuing their 1997 memorandum that was intended to satisfactorily address this problem until federal rule making to correct the problem can be conducted:

> "EPA will accept a CPA's report describing the procedures performed and related findings, including whether or not there were discrepancies found in the comparison, based upon agreed-procedures engagement performed in accordance with [the new FASB standards] . . . The Agency will regard this report as satisfying the requirements of the Financial Test . . . for a special report by an independent CPA . . ."

There is no reason why the Department can't follow suit with essentially the same guidance. A rule making is probably eventually necessary, but is not advisable to correct this problem until the US EPA resolves it through rule making at some future date. For the Department to forge ahead with rule-making now would simply run the risk of potential continuing discrepancy at some future date when EPA ultimately adjusts its regulations to eliminate the "negative assurance".

Until the US EPA makes the necessary changes to its regulations the Department should likewise rely on enforcement discretion and accept the new FASB procedures – just as US EPA has done.

Assets Used as Security Should Not Be Excluded from the Computation of Tangible Net Worth for Companies with Bond Ratings

The DTSC has suggested that assets pledged as security for indebtedness should not count toward the tangible net worth requirements in the financial test. We disagree.

Companies that qualify for the use of the Financial Test based on their published bond ratings should not have to adjust their tangible net work in this manner. The bond ratings already take into account all of their assets and liabilities – including both the net value of pledged assets and also the debt secured by those assets. For companies relying on strong bond ratings to use the Financial Test the added computation of tangible net worth will add very little.

The Amounts Included on Line 1 of the Department's Financial Assurance forms should Include all Financial Test Obligations throughout the United States.

In fact, this is exactly how Waste Management bases its computations of available financial assurance using the Financial Test. We include all obligations throughout the United States – not just California facilities -- in which the Financial Test is being relied upon to provide Financial Assurance. *We have no objection to this change provided it is limited to those nationwide financial assurance obligations for which the company is using the Financial Test.*

The Altman's Z Score Option should NOT be required.

For the reasons provided by the American Chemistry Council in its comment letter to the Department dates November 14, 2005, Waste Management suggests that this change is not supported and would be unwise as a formal regulatory tool. Further, the Department

has not provided precise references to which of the Altman's Z score protocols to which you have been referring in the workshops. We are extremely concerned that many of the Altman's Z Score protocols do not take into account the "service" nature of many of the companies engaged into the waste business. Even thought these companies are financially strong the absence of marketable inventory has rendered certain Altman Z Score formulas unworkable for the waste services industry.

If the Department persists in consideration of the Altman Z Score, we request that a focused workshop be held to clearly articulate what Altman Z Score procedures you are suggesting be used and the supporting documentation that accompanies such a proposal. Although the use of Altman Z Score is fraught with difficulties as suggested by the American Chemistry Council, Waste Management would be less concerned about the use of this a tool if restrictions on the percentage use of the Financial Test to meet all financial obligations were based on nationwide use of all financial assurance mechanisms – not just in California. This would be consistent with what the Department has proposed to clarify in line 1 of the Financial Test form – use of the Corporate Guarantee should look at all nationwide use of this mechanism – not just that portion used in California.

For example, Waste Management might use the Financial Test to cover 100% of the Post-Closure care cost at its single California Kettleman Hills Treatment Facility. However, nationwide Waste Management, as indicated in the front of this letter, only uses the Financial Test to meet 13% of total hazardous waste facility financial assurance obligation and only 6% of its solid waste facility financial assurance obligation. Thus, we would expect that if Waste Management were ever in a category, as suggested by the Department, where use of the Financial Test might be limited – such limitation would be applied to the nationwide use of the Financial Test – but only if we were to use it in California.

There is no Basis for Increasing the $10 Million Tangible Net Worth Requirement

Waste Management can easily meet any reasonable new amount adjusted upward for inflation. For example, a $20 million tangible net worth requirement would not pose a problem for Waste Management. Although we would not object to such a change, we are not convinced it is necessary. We suspect that any companies using the Financial Test are well in excess of this amount in any event and it would be change with no effect. However, before the Department pursues such an upward adjustment we request that a more thorough analysis be performed on the impacts of such an adjustment. It is not clear what additional security would be gained from making this regulatory change.

Summary

In conclusion, Waste Management believes that wholesale changes to the financial assurance regulations suggested by the Department – at least with respect to Captive Insurance and the Financial Test -- are not warranted. These are the best two performing financial assurance mechanisms in use today. Restricting access to these mechanisms

would only serve to push facility operators toward mechanisms that are significantly more costly and with no better track record than these two mechanisms.

If the Department does proceed with regulatory action in this area, we believe that such action should be limited to the following issues:

1. ***Assignability.*** Resolution of assignability problem that currently exists with respect to the use of Captive Insurance. There is no reason to retain the requirement that Captive Insurance policies be assignable when the facility is sold to a new owner. The Department has complete control over ensuring that the new owner will have adequate financial assurance before the permit is transferred.
2. ***Negative Assurance.*** The Department should exercise enforcement discretion consistent with US EPA and not make changes to the regulation until the federal regulations are amended to correct this problem.
3. ***Line 1 of Financial Test Form.*** The Department should clarify that all nationwide uses – not just those in California -- of the financial test for closure, post-closure care, and corrective action should be included.

Respectfully, Waste Management does not believe that any further changes to the financial assurance regulations for the use of Captive Insurance or the Financial Test are warranted at this time. Of course, Waste Management would be willing to cooperatively participate in any more focused workshops that the Department may believe are warranted. Please contact me at your convenience if you have any questions or concerns regarding these comments or if WM can be of any further assistance.

Sincerely,

Original Signed By:

Charles A. White, P.E.
Director of Regulatory Affairs
Waste Management/West

Attachments: A -- *WHAT IS CAPTIVE INSURANCE AS REGULATED BY THE STATE OF VERMONT?*

B -- INSURANCE COMPANIES KNOWN TO HAVE FAILED OR BECOME INSOLVENT

C -- *REGULATORY AND OTHER CONTROLS PLACED BY THE STATE OF VERMONT ON CAPTIVE INSURERS*

D -- CAPTIVE INSURANCE COMPANIES LICENSED BY VERMONT AND AMOUNT OF PREMIUMS

Cc: Maureen Gorsen, Director, DTSC
Peggy Harris, Branch Chief, DTSC
Jan Radmisky, Section Chief, DTSC

ATTACHMENT A

WHAT IS CAPTIVE INSURANCE AS REGULATED BY THE STATE OF VERMONT?

What is a Captive Insurer?

- A captive insurer is a company that is owned or controlled by its policyholders, thereby enhancing the company's ability to control costs.
- Through captives, business owners have access to broader, less expensive insurance markets.
- Provides an option for many corporations that want to take financial control and manage risks by underwriting their own insurance rather than paying premiums to third-party insurers.
- Vermont constructed a regulatory system to ensure the solvency of captives while recognizing the special purposes for which they were formed.
- The number of captives licensed in Vermont continues to grow sharply, with over 700 licenses issued as of 2005. Vermont is the largest captive domicile in the U.S.
- There are over 4,000 captive companies worldwide.

Benefits of a Captive

- Coverage tailored to meet the needs of a company - A captive can tailor its own insurance policy for the coverage the parent requires. This means that the insured does not have to accept standard policy forms that may not provide the exact coverage the insured needs.
- Reduced operating costs - Insurance purchased in the conventional insurance market includes an allocation of the insurer's overhead. These costs can be very significant, especially when compared to the costs of running a captive.
- Improved cash flow - The parent of the Captive Insurance Company has control over the premium flow and can use the premium to generate investment income. This income can be used to offset the cost of running the captive and payment of future losses.
- Increased coverage and capacity - The cyclical nature of the insurance industry means that there are times of limited capacity and dramatic premium increases. This occurs when insurance companies are not prepared to provide insurance buyers with the coverage they require. The captive can be utilized in resolving

market problems and providing a continuity of coverage for a price the insured is prepared to pay.

- Direct access to wholesale reinsurance markets - The captive can have direct access to the reinsurance markets around the world. This can help to lower the program costs, as the ceding commission paid to the primary insurer will now belong to the captive.
- Incentives for loss control - A centralized risk management program can improve and promote better loss control. This is particularly appropriate for diversified or multinational corporate groups where the different requirements of numerous subsidiaries can be consolidated and managed under one program.

Reporting Requirements

- Report of its financial condition, verified by oath of two of its executive officers.
- Annual audit by an independent certified public accountant, authorized and filed with the commissioner, to include:
    - Opinion of Independent Certified Public Accountant
    - Report of Evaluation of Internal Controls
    - Accountant's letter stating
        - He/She is independent with respect to the company
        - General background and experience of the staff engaged in audit including the experience in auditing captives and other insurance companies
        - Accountant understands the report and opinions thereon will be filed in compliance with Regulation 81-2 with the Dept of Banking and Insurance.
        - Accountant consents to review of the work papers prepared in the conduct of the audit
        - Accountant is properly licensed by an appropriate state licensing authority and he is a member in good standing in the American Institute of Certified Public Accountants.
    - Financial Statements
        - Balance sheet
        - Statement of gain or loss from operations
        - Statement of changes in financial position
        - Statement of changes in capital paid up, gross paid in and contributed surplus and unassigned funds (surplus)

        - Notes to financial statements
    - Certification of Loss Reserves and Loss Expense Reserves

- Designation of Independent Certified Public Accountant – Companies must report to the commissioner, in writing, the name and address of the independent CPA retained to conduct the annual audit.
- Notification of Adverse Financial Condition
    - CPA must immediately notify in writing an officer and all members of the Board of Directors of the company of any determination by the CPA that the company has materially misstated its financial condition in its report to the commissioner.
    - Company shall furnish such notification to the commissioner within five (5) working days of receipt.
- Work Papers
    - Independent CPA shall make available for review by the commissioner or his appointed agent the work papers prepared in the conduct of the audit.
    - Company shall require that the accountant retain the audit work papers for a period of not less than five years after the period reported upon.
- Deposit Requirement
    - Commissioner can require a company to deposit additional security if he deems the financial condition of the company warrants it.
    - If a company discontinues business, the commissioner will return a deposit only after being satisfied all obligations have been discharged.
- State Examinations and Investigation - Conducted every three to five years, or earlier if the commissioner determines it to be prudent.
- Biographical affidavits outlining the background of every officer, director and key employee.
- Any change to a captive's plan of operations must be pre-approved by the commissioner.
- Parent Company Annual Reports must be submitted annually and the financial condition of the parent is monitored continually by the regulators throughout the year.

Attachment B

INSURANCE COMPANIES KNOWN TO HAVE FAILED OR BECOME INSOLVENT -- NONE ARE KNOWN TO BE VERMONT REGULATED CAPTIVE INSURANCE COMPANIES

Company	Estate No.	Date Impaired
Acceleration National Insurance Company (GA)	816	03/21/2001
American Eagle Insurance Company (TX)	496	12/22/1997
American Guardian Ins Underwriters Lloyds (TX)	447	01/14/1991
American Mutual Liability Insurance Co (MA)	394	04/21/1989
Aries Insurance Co (FL)	826	03/17/2003
Bell Indemnity Company, Inc. (TX)	468	08/04/1992
Cascade Insurance Company (LA)	484	09/17/1993
Colonial Casualty Insurance Company (TX)	510	09/19/2002
Comco Insurance Company (TX)	465	02/05/1992
Commercial Compensation Casualty Co (CA)	813	09/29/2000
Commercial Standard Insurance Company (TX)	301	05/31/1985
Credit General Indemnity Company (OH)	814	12/15/2000
Empire Llyds Insurance Company (TX)	513	01/08/2003
Employers Casualty Company (TX)	487	01/06/1994
Employers National Insurance Company (TX)	490	01/18/1994
Employers of Texas Lloyd's (TX)	489	01/18/1994
Equity American Insurance Company (TX)	456	08/13/1991
Financial Insurance Company of America (TX)	522	05/27/2005
Fremont Indemnity Company (CA)	829	07/10/2003
First Southern Insurance Company (FL)	800	10/13/1992
General Aviation Insurance Company (TX)	488	01/14/1994
Great States Insurance Company (CA)	817	05/14/2001
Guaranty County Mutual Insurance Co (TX)	479	05/11/1993

HIH American Compensation & Liability (CA)	818	05/14/2001
The Home Insurance Company (NH)	827	06/26/2003
Ideal Mutual Insurance Company (NY)	300	03/22/1985
Insurance Corporation of America (TX)	494	04/01/1997
Integrity Insurance Company (NJ)	343	10/06/1987
International Indemnity Company (GA)	815	01/25/2001
International Lloyds Insurance Company (TX)	492	04/09/1996
International Service Insurance Company (TX)	459	12/12/1991
International Underwriters Insurance Co (DE)	803	03/22/1993
Lutheran Benevolent Insurance Exchange (MO)	810	12/02/1996
Legion Insurance Company (PA)	824	10/25/2002
Members Mutual Insurance Company (TX)	473	08/12/1992
Midland Insurance Company (NY)	322	07/09/1986
The Millers Insurance Company (TX)	514	03/14/2003
Mission Insurance Company (CA)	331	03/20/1987
Mission National Insurance Company (CA)	332	03/20/1987
National Allied Insurance Co of Texas (TX)	328	09/15/1986
National Automobile and Casualty Insurance Co. (CA)	823	06/28/2002
National County Mutual Fire Insurance Co (TX)	371	02/09/1989
Pacific Marine Insurance Company (WA)	411	10/02/1989
Paula Insurance Company (CA)	822	06/25/2002
Petrosurance Casualty Company (OK)	821	03/15/2002
PHICO Insurance Company (PA)	820	02/05/2002
Premier Alliance Insurance Company (CA)	807	08/19/1994
Professional Medical Insurance Company (MO)	805	04/15/1994
Reciprocal of America (VA)	828	06/27/2003
Reliance Insurance Company (PA)	819	10/05/2001
Rockwood Insurance Company (PA)	464	10/16/1991
SIR Lloyd's Insurance Company (TX)	461	03/12/1992
Standard Financial Indemnity Corp. (TX)	462	03/12/1992
Superior Pacific Casualty Company (CA)	812	09/29/2000

Texas Citrus & Vegetable Ins Exchange (TX)	475	12/04/1992
Texas Employers Indemnity Company (TX)	466	11/20/1991
Texas Employers' Insurance Association (TX)	450	12/11/1990
Transit Casualty Company (MO)	313	12/18/1985
Underwriters Lloyds Insurance Company (TX)	480	06/15/1993
United Community Insurance Company, (NY)	808	09/01/1994
United Southern Assurance Company (FL)	811	09/18/1997
Villanova Insurance Company (PA)	825	10/25/2002
Western Employers Insurance Company (CA)	457	06/04/1991
Western Indemnity Insurance Company (TX)	516	06/11/2003

Attachment C

REGULATORY AND OTHER CONTROLS PLACED BY THE STATE OF VERMONT ON CAPTIVE INSURERS

This is a listing of the various regulatory filings and procedures with which National Guaranty Insurance Company of Vermont ("NGIC") is required to adhere as a licensed Captive Insurance company in the State of Vermont.

1. Annual Loss Certification:

NGIC is required to have an annual certification of its outstanding Incurred But Not Reported ("IBNR") and case reserves performed by an independent third party (these actuaries must also be approved by Vermont to perform this certification) opining on the adequacies of these liabilities. This certification is filed with the Vermont Department of Banking, Insurance, Securities and Health Care Administration (the Vermont Department).

2. Annual Audit:

NGIC is required to have an annual audit of its financial statements (the CPA signing the audit must also be approved by Vermont) that is also filed with the Vermont Department.

As part of the audit, Marsh Vermont and an officer of NGIC will sign a management representation letter verifying that the captive has provided all the relevant, accurate and complete information needed to complete the audit. The auditor also reviews the reserve calculations done by the actuary, as part of the audit.

3. VT Annual Report:

NGIC files annually by February 28th a report with the Vermont Department detailing the prior year end financial position as well as the insurance activity of the captive; this report is prepared by Marsh and signed by two executive officers of the captive. If the audited financial statements differ from the financials filed by Marsh with the Vermont Department, a reconciliation must be prepared as part of the audit.

4. VT Regulatory Examination

The Captive Division of the Vermont Department performs a regulatory examination of all captives every 3 to 5 years to verify the captive is operating within the parameters of its license as well as its Articles and By-Laws. This examination also includes a detailed review of policies, reinsurance agreements, loss runs, annual audit reports, loss certifications and the records of the captive, to be sure that the terms and conditions of all the various agreements comport with the activities of the captive.

5. Financial Statement Preparation:

Internal financial statements for NGIC are prepared on a quarterly basis by Marsh. The statements are first prepared by the account administrator pulling information from the

third-party claims administrator, investment manager, and internally generated information. The statements then go through a detailed review by the Senior Account Manager. In the case of NGIC, the Senior Account Manager is Susan D. Precourt, CPA.

6. Cash controls:

Marsh also has an extensive cash control policy for all captives under its management to ensure that those individuals involved in the accounting for an individual captive are not involved in the cash handling or check writing process for that same captive. If you would like the complete details of the Marsh cash control procedures, please let Ms. Precourt know.

7. Annual Board of Directors meeting:

Vermont requires that an annual meeting of the Board of Directors be held in Vermont to review the activities of the captive. At this meeting, Marsh presents the internal financial statements and the prior year's audit, a review of investments held, a summary of all operations, signature authority on bank accounts, a complete compliance checklist, and many other operational details, and answer questions from the Board.

Attachment D

CAPTIVE INSURANCE COMPANIES LICENSED BY VERMONT AND AMOUNT OF PREMIUMS